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RELATING FISCAL AUDITING TO COMPLIANCE AUDITING

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One of the very significant challenges that has recently come to the forefront in the accounting profession in the United States is the need to delineate clearly the role of the CPA in the performance of audits other than the traditional examination of financial statements. One of the most important problems has been the determination of the extent to which generally accepted auditing standards, as developed for guidance of CPAs in conducting financial audits, apply to compliance and performance audits. To the extent that such standards have been determined to be inapplicable, new standards have, of course, had to be developed.

It is in the field of government rather than industry that the effort to develop standards for such audits has been spearheaded, particularly at the federal level. The basic need of Congress to determine that federal grants to states and local governments are properly spent—specifically, to determine that there has been compliance with the related requirements of each grant or program; that such funds have been spent with economy, efficiency and effectiveness; and that the basic goals of the grants are being achieved—requires that compliance and performance audits be performed. Therefore, even though development of standards is difficult, it has been urgent that they be established.

It seems both appropriate and desirable first to discuss briefly the nature of auditing standards and the manner in which they have been developed in the accounting profession to date.

DEVELOPMENT OF GENERALLY ACCEPTED AUDITING STANDARDS

As early as 1917 the American Institute of Certified Public Accountants prepared a memorandum on "Balance Sheet Audits," which was published by the Federal Reserve Board in 1918. This initial publication was revised in 1929 and reissued under the title, "Verification of Financial Statements." In 1936 it was again revised and reissued under the Institute's sponsorship in a

pamphlet titled "Examination of Financial Statements by Independent Public Accountants."

In 1939 the Institute formally established its Committee on Auditing Procedure, and over the ensuing twelve-year period it issued a total of twenty-four bulletins. These were codified in 1951. Meanwhile, as a result of a special study for the purpose of determining and explaining standards, the Committee in 1947 issued a report, "Tentative Statement of Auditing Standards—Their Generally Accepted Significance and Scope."

By 1963 a total of thirty-two bulletins had been issued, all of which were revised and incorporated into the now well-known document, *Statement on Auditing Procedure No. 33*. From 1963 to November 1972 twenty-one additional bulletins were issued, and at that time all of these bulletins were codified again, being organized into what is now known as *Statement on Auditing Standards No. 1*.

It should be noted at this point that throughout the long period in which the audit function has been exercised by independent auditors in the separate fields of private enterprise and the nonprofit area, including government, as well as by auditors serving exclusively in the field of government, these standards developed by the AICPA have been the only ones available for guidance.

The Committee on Auditing Procedure (now the Auditing Standards Executive Committee) of the American Institute of Certified Public Accountants has made a distinction between auditing standards and auditing procedures and thus left with us an acceptable definition of auditing standards:

Auditing standards differ from auditing procedures in that "procedures" relate to acts to be performed, whereas "standards" deal with measures of the quality of the performance of those acts and the objectives to be attained by the use of the procedures undertaken. *Auditing standards* as distinct from *auditing procedures* concern themselves not only with the auditor's professional qualities but also with the judgment exercised by him in the performance of his examination and in his report.¹

In the observance of generally accepted auditing standards, the independent auditor must exercise his judgment in determining which auditing procedures are necessary in the circumstances to afford a reasonable basis for his opinion. His judgment is required to be the informed judgment of a qualified professional person.²

As these auditing standards have been developed over the years by the AICPA, they have been intended to apply basically to audits of business enterprises in the private sector and, within that sphere, only to audits of

financial statements—so-called “financial or fiscal audits.” Nonetheless, it is widely accepted that these standards generally apply to nonprofit organizations, including the field of government.

The important distinction here does not relate so much to the kind of organization (business or nonprofit) to which the standards apply, as to the particular type of audit. The standards were developed to apply specifically to certified public accountants in their conduct of financial or fiscal audits, i.e., the examination of financial statements and the rendition of an auditor’s opinion thereon. This is a most important distinction and has had a significant bearing on the approaches already taken in the broad development of auditing standards for the entire public sector.

What are the auditing standards developed by the AICPA that are considered to be generally accepted? Some time ago the Institute’s Committee on Auditing Procedure developed ten basic standards governing the conduct of certified public accountants in the audit of financial statements of business or other organizations. As a foundation for a later discussion of audits other than of financial statements, it seems important to take a close look at these standards:

General Standards

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.

2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.³

As stated above, all of these standards when prescribed were intended to relate to, and only to, audits of financial statements. Let me repeat: The accounting profession in this country has not to date officially prescribed any standards for any other kind of audits, such as compliance or performance (or operational) audits. A policy statement on compliance audits was approved by the Institute's Council some years ago, but that is the only official action that has ever been taken. The substance of this statement, plus considerable explanatory material, has been incorporated in a booklet issued by the AICPA.⁴

Notwithstanding all of the foregoing, the Comptroller General of the United States has now prescribed standards for compliance and performance or operational audits, although the official publication describes these as "Standards for Audit of Governmental Organizations, Programs, Activities & Functions." This distinction may be further emphasized by quoting from the Comptroller's publication:

The American Institute of Certified Public Accountants (AICPA) has adopted standards and procedures that are applicable to audits performed to express opinions on the fairness with which financial statements present the financial position and results of operations. These standards are generally accepted for such audits and have been incorporated into this statement. However, the interests of many users of reports on Government audits are broader than those that can be satisfied by audits performed to establish the credibility of financial reports. To provide for audits that will fulfill these broader interests, the standards in this statement include the essence of those prescribed by the American Institute of Certified Public Accountants and additional standards for audits of a broader scope⁵

DEVELOPING STANDARDS FOR COMPLIANCE AUDITS BY THE AICPA

- **Types of Audits in the Public Sector.** As a prelude to a further discussion of the relationship of financial or fiscal auditing to compliance auditing, it is

desirable first to classify the types of audits involved in the public sector:

1. Financial audits
2. Compliance audits
3. Performance audits

Performance audits, as the term is used here, are those described in the GAO publication as undertaken "for economy, efficiency, and achievement of desired results."⁶ The development of standards for such audits by the AICPA is beyond the purview of this paper.

- **Financial Audits.** Certainly the accounting profession sees no problem as to financial audits. As previously made clear, the auditing standards are fully established, and the members of the profession nationwide hold themselves out to be competent and qualified to conduct examinations of financial statements of business enterprises and nonprofit organizations. The same should be equally applicable to internal audit staffs of state governments with respect to any audit work they perform that would be characterized as a financial or fiscal audit.

As stated above, the GAO publication has adopted the AICPA standards relating to financial audits, and there is now uniform thinking on the subject of standards for such audits.

- **Compliance Audits.** While to date no official standards for compliance audits have been established by the AICPA, the profession is presently guided by the long-standing position of the AICPA Committee on Relations with the Federal Government, which is quoted in the Institute's 1972 committee report on federal agencies' audit guides:

The committee noted that its components' activity has revealed a rapidly growing buildup in compliance work, often as an adjunct to audits. . . . Noting that compliance requirements are often motivated by statute, the committee points out that criteria applied to compliance work may differ very fundamentally from those involved in auditing. With this in mind, the committee reaffirmed its position that compliance work should be encouraged, as long as the accountant's area of responsibility is clearly defined, and where the accountant's skills equip him for the task. The senior committee suggested that this area receive increasingly extensive coverage in American Institute publications.⁷

Thus, it was made clear a number of years ago within the Institute that standards must be developed for this specialized and growing field. The 1972 report further points out that:

It will be difficult, at best, to distinguish every compliance item as being either a financial compliance item or a program compliance item. Some matters are clearly one or the other, while others may not be so easily classified. . . . It does not seem feasible that a general audit guide can include a comprehensive list of compliance items suitable for all grants or contracts. However, some rather comprehensive but nonetheless broad instructions would be appropriate to establish the framework in which the auditor can and is expected to function. In those cases where the auditor's effort in determining compliance is incident to and a by-product of those audit procedures primarily concerned with determining the fairness of financial reports, his responsibility is limited to disclosing those aspects of non-compliance which are ascertained in the performance of such procedures. On the other hand, where the auditor's engagement specifically identifies the effort to be expended for the direct purpose of examining compliance with various requirements, then his responsibility is such as to require the performance of adequate work so as to permit him to report with regard to those aspects of compliance so examined.⁸

Again, in specifically discussing the auditor's opinion on systems surveys and financial compliance matters, the report states that:

. . . systems surveys and financial compliance engagements with specific reporting requirements may be undertaken in conjunction with a financial audit or separately. When they are undertaken in connection with a financial audit, it should be noted that a CPA, in conducting an examination of financial statements in accordance with generally accepted auditing standards, has a responsibility to study and evaluate the system of internal control. The purpose of the study and evaluation is to establish a basis for reliance thereon in determining the nature, timing, and extent of audit tests to be applied in connection with the expression of an opinion on financial statements.⁹

By comparison it is of interest to note that the new GAO audit standards link together financial and compliance audits. The first of three elements of an audit is defined as: "*Financial and compliance*—determines (a) whether financial operations are properly conducted, (b) whether the financial reports of an audited entity are presented fairly, and (c) whether the entity has complied with applicable laws and regulations."¹⁰ In the normal context, the term "financial (or fiscal) audit" includes all financial compliance matters; however, it excludes nonfinancial compliance matters, as appear to be included in the new GAO standards stated above.

In the special areas of compliance, the GAO standards recognize with the AICPA that federal or state agencies requiring audits at lower levels should provide adequate guidelines for such audits:

. . . Therefore, to provide the auditor with the necessary background information and to guide his judgment in the application of the accompanying standards,

Federal or State agencies that request State, local, or other levels to make audits are expected to prepare broad, comprehensive audit instructions, tailored to particular programs or program areas.

The content of such audit guidance should include a digest of, or as a minimum, citations to applicable statutes, regulations, instructions, manuals, grant agreements, and other program documents; identification of specific audit objectives and reporting requirements in terms of matters of primary interest in such areas as program compliance, economy, and effectiveness; and other audit guidelines covering specific areas in which the auditor is expected to perform.¹¹

There is an interesting contrast between AICPA pronouncements and the GAO publication with respect to the necessity of a review of the system of internal control in the organization or agency being audited. The AICPA has required such review as a field work standard as a basis for expression of an opinion as to fair presentation of financial statements. The new GAO standards extend the requirement to review the system of internal control to the compliance aspect of an audit:

The review should be sufficient to permit the auditor to determine whether policies, procedures, and practices are consistent with the applicable laws and regulations and whether the system of internal control can be relied upon to provide reasonable assurance that such policies and practices are being followed.¹²

Reporting on Compliance Audits. The AICPA committee report sets forth some specific recommendations on reporting requirements. Perhaps the most important is the following:

It is believed essential that the review of compliance with program requirements which necessitates examination beyond that typically identified with the audit of financial records and related audit procedures should be separately identified in the preparation of audit guides by federal agencies and should be reported upon in a separate section of the audit report.¹³

The report also states that, particularly with respect to the auditor's opinion, the AICPA *Statements on Auditing Procedure* should be useful reference guides. Further:

Where the auditor's services in a particular engagement include a systems survey and/or compliance work, as well as a financial audit, it is to be recognized that his report will deal separately with the different services. The audit guide generally should provide for this by an illustrative report structure or format which clearly separates the statements, schedules, and other information pertaining to the separate services. This may be accomplished by a report comprised of separate parts for different services, or by a separate report for each service . . .

... if specific reporting is required on a grant or contract, it should be understood that extended audit procedures related thereto are required. When the grant or contract agreement requires separate reports in these areas, the CPA's report should describe the procedures followed, the findings resulting from tests and, if appropriate, suggested improvements.¹⁴

In an appendix the report offers three useful examples of opinions on compliance audits.

CONCLUSION

To sum up what has been said so far: Until recent years the only kind of audit generally performed was the financial or fiscal audit. Such audits comprised examination of financial statements of business enterprises or non-profit organizations, including governmental units, for the purpose of expressing an opinion on financial position and results of operations. The auditing standards for such audits were developed and promulgated by the American Institute of Certified Public Accountants many years ago, the initial efforts having been made as far back as 1917.

While these auditing standards were promulgated for the guidance of certified public accountants engaged in public practice who were members of the AICPA, they were generally followed by non-member CPAs and public accountants in those states where they were licensed or otherwise permitted to practice. In addition, internal audit staffs of business enterprises and governmental organizations, of which the audit staffs of a state auditor's office and a state agency are excellent examples, have subscribed for years to these basic standards with respect to fiscal audits.

Many financial audits of business enterprises have compliance aspects. For example, (1) the declaration of a dividend by a corporation's board of directors and (2) approval of a stock split by the stockholders. However, very few audits for commercial organizations are performed solely for compliance purposes.

As compared with a business enterprise, however, the financial audit of a governmental unit has many more compliance aspects. Examples that come readily to mind are (1) compliance of actual expenditures with budget appropriations and (2) crediting of earmarked or restricted revenues in the legally designated fund. There is also an increasing number of purely compliance audits in government, i.e., audits containing only financial and non-financial compliance requirements—for example, an audit by or for a federal agency to determine compliance with all of the specific use requirements of a federal grant.

Technically, no standards have been officially prescribed by the AICPA for compliance audits per se; standards for compliance aspects of financial audits are considered to be encompassed in generally accepted auditing standards. The Council of the Institute has not yet gone beyond its adoption some years ago of the policy statement incorporated in the 1972 report of the Institute's Committee on Auditing for Federal Agencies. In substance, this report states that criteria applied to compliance work may differ very fundamentally from those involved in fiscal auditing and that compliance work should be encouraged so long as (1) the accountant's area of responsibility is clearly defined and (2) his skills equip him for the task.

Going beyond the original policy statement, the report states that any audit guides prepared by federal agencies should make it clear whether compliance work is to be pursued only incident to the financial audit, or the financial audit procedures are to be extended to cover some specific compliance matters. It further points out the frequent mixture in a compliance audit of financial and program compliance items and the recurring difficulty of distinguishing between them. It is made clear that where the auditor's effort in determining compliance is a byproduct of fiscal audit procedures, his responsibility is limited to those aspects of noncompliance that are ascertained in the performance of such procedures. On the other hand, if a given engagement specifically identifies compliance requirements, the auditor will perform adequate work to permit him to report with regard to those aspects of compliance examined.

It has also been pointed out that federal and state agencies for which compliance audits are required should furnish broad, comprehensive audit instructions or, at the very least, reasonable guidelines and criteria for the conduct of each examination.

The viewpoint within the profession as to reporting on fiscal and compliance audits is that a single report is suitable for a fiscal audit with which there are associated financial compliance aspects. However, if the audit involves program or other nonfinancial compliance items, such items should be reported upon either in a separate section of the audit report or in a separate report. The new GAO standards appear to indicate that such items can be reported upon in either a single report or in separate reports.

Finally, it is well to express the viewpoint that the broad general public, including the accounting profession, owes a debt of gratitude to the General Accounting Office, and to the several other cooperating federal agencies, for leadership in trying to develop workable auditing standards for both compliance and performance audits. They have responded to the need of federal and state governments to receive independent assurance that governmental

resources are expended for their intended purposes and that social services and benefit programs attain their designed objectives. The accounting profession has been provided with a remarkable opportunity to expand the areas of its professional service and concurrently to serve the public good in an unprecedented fashion. •

1. Committee on Auditing Procedure, "Codification of Auditing Standards and Procedures," *Statement on Auditing Standards No. 1* (New York: American Institute of Certified Public Accountants, 1973), Sec. 150.01.
2. *Ibid.*, Sec. 110.04.
3. *Ibid.*, Sec. 150.02.
4. Committee on Auditing for Federal Agencies, *Suggested Guidelines for the Structure and Content of Audit Guides Prepared by Federal Agencies for Use by CPAs: A Report* (New York: American Institute of Certified Public Accountants, 1972).
5. Comptroller General of the United States, *Standards for Audit of Governmental Organizations, Programs, Activities & Functions* (Washington, D.C.: U.S. General Accounting Office, 1972), p. 1.
6. *Ibid.*, p. 2.
7. *Suggested Guidelines for . . . Audit Guides Prepared by Federal Agencies*, pp. 5-6.
8. *Ibid.*, pp. 6-7.
9. *Ibid.*, p. 9.
10. *Standards for Audit of Governmental Organizations*, p. 2.
11. *Ibid.*, pp. 4-5.
12. *Ibid.*, p. 33.
13. *Suggested Guidelines for . . . Audit Guides Prepared by Federal Agencies*, p. 10.
14. *Ibid.*, pp. 8-9.